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23 December 1974

MEMORANDUM FOR: Mr. Michael Armacost
Policy Planning Staff
Department of State

SUBJECT : South Korea: Status of the Economy

In response to your request we are forwarding the attached report on South Korea: Status of the Economy. for use in preparing a policy planning paper on South Korea. South Korea's economic slowdown, already the most serious in years, is likely to extend well into 1975. The downturn largely reflects sagging foreign demand for South Korean exports. If there are any further information on this or related matters we would be happy to oblige.

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Attachment:
As stated

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SOUTH KOREA: STATUS OF THE ECONOMY

KEY CONCLUSIONS

- South Korea faces its steepest economic slump in years with the downturn likely to last well into 1975.

- The chief cause of the slump will be slackening foreign demand for South Korean goods in the United States and Japan which take nearly 70% of exports.

- With unemployment on the rise and inflation still a problem the economic situation will exacerbate the government's already growing political difficulties.

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THE SOUTH KOREAN ECONOMY

1. South Korea is well into its most pronounced economic slump in a decade. Although real growth this year will average at most 8%, all the gains have come in the first half. The downturn will extend well into 1975 when real growth will probably register only slight gains. Growth prospects have declined essentially because of the economic downturn in major industrial countries which account for the bulk of Korea's exports and supply a large share of investment funds. Problems stemming from slow growth will add to Seoul's already growing political problems.

The Emerging Slump

2. The economy expanded rapidly during the first half of 1974 but the pace slowed sharply after mid-year. Real gross national product during the first half was 15% above the same 1973 period while industrial output was 27% above last year's average. In recent months, however, industrial output has declined because of weak foreign demand for South Korean goods. With no turnaround expected in the months ahead, real GNP will register no gain during the second half of 1974 compared with the first.

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3. The downturn has been concentrated in a relatively few industries. The hardest hit include textiles, plywood, electronics and other light consumer manufacturers that export the bulk of their output. Output in the important textile industry, for example, is down over 10% from the early 1974 peak, the sharpest decline in years. Although heavy industry continues to do relatively well, output gains there also have slowed in recent months.

4. Unemployment, is already on the rise. Layoffs so far this year have totaled some 100,000 factory workers, roughly 2% of the labor force. Several major US and Japanese firms in Korea are planning substantial layoffs. Most foreign and locally owned firms, however, are maintaining their labor force, preferring instead to reduce work hours when necessary. Nonetheless, employer groups and the government are concerned over the likelihood of increased labor unrest, particularly in urban areas.

Government Policies

5. Seoul's primarly economic objective has shifted from controlling inflation to maintaining employment and output. To accomplish this the government has reversed its fiscal policy. The budget -- in surplus during the first nine months of 1974 -- is now running a sizeable deficit. Seoul is increasing spending on public works,

welfare, defense and government industrial projects. The public works program is essentially aimed at offsetting the decline in private sector employment. Seoul is also providing special loans from budgeted funds and government-owned banks to private businessmen to help avoid a rash of bankruptcies.

6. Seoul also announced an 18% devaluation of the won on 7 December to stimulate exports and dampen imports. To help offset the inflationary impact of devaluation, Seoul has tightened its monetary policy somewhat by raising reserve requirements and interest rates. The government also plans to control price increases on 58 key commodities, although it has adjusted petroleum products prices and electricity rates by 31% and 42%, respectively, to reflect increased oil prices and the won devaluation.

7. Despite monetary tightening, inflation shows no signs of easing. Consumer prices in November were 27% above last year's level, while wholesale prices were up 44%. The won devaluation and energy-related price adjustments are likely to boost wholesale prices nearly 10% in December alone. Nevertheless, Seoul hopes to hold inflation next year to around 15% -- half this year's expected rate. This may prove difficult, however, because of pressures for large catch-up wage hikes and only small productivity gains.

Trade and Payments

8. Higher oil and other commodity prices have boosted Korea's trade deficit sharply. For the year as a whole, it will reach $1.5 billion. Although export value has risen 40%, imports are up 60%, largely because of higher oil prices. Higher prices account for most of the export gains; sales volume this year will be up about 15% compared with 60% in 1973.

9. This year's current account deficit will approach $1.5 billion compared with $300 million in 1973. Most of the deficit is being offset by long-term capital inflows stemming in part from investment commitments made last year. Some slowdown in direct investment inflows, particularly from Japan, appears evident, however. The Japanese have cut back their investment plans because of political problems between the two countries as well as for economic reasons. US investment commitments have also slowed.

10. The Koreans have substantially increased their short-term borrowing abroad. This borrowing reached an estimated $400 million during the first half of 1974. Korea's good international credit rating and low debt service payment -- 11% of exports in 1973 compared with 20% the previous year -- has made it relatively easy to obtain these funds. Depsite increased borrowing, however, foreign reserves have declined sharply in recent months, falling from $1,015 million at the end of September to $931 million by late November.

The 1975 Outlook

11. Slow growth and balance of payments stringencies will likely persist through 1975. Real growth next year may well be only half Seoul's recent 7% forecast. The chief problem will be continued weak Japanese and US demand for South Korean goods. Japanese imports from South Korea have declined particularly fast in recent months, with no improvement in sight, and South Korean exporters are beginning to have problems boosting sales to other markets. Australia and Canada, for example, recently placed new controls on textile imports from Korea.

12. Because weak demand is the chief factor curtailing export growth, the recent won devaluation will not boost overseas sales very quickly. Even if export volume fails to increase significantly, however, overseas sales value will grow by 20-25% because of higher prices. Import costs will be up somewhat because of higher food and oil costs. Under these circumstances, we expect the trade balance to improve little, if at all, and the current account deficit will probably approach the 1974 level of $1.5 billion.

13. To avoid any further drawdown of foreign exchange, Seoul hopes to increase its long-term foreign borrowing. Negotiations have been underway to borrow $600 million from Middle Eastern oil exporting countries. Another $1.5 billion is being sought from the World Bank, the Asian Development Bank, as well as the US, Canada, Japan and West European countries. Seoul feels that it will be able to obtain enough

funds from these sources to avoid any further worsening of balance of payments position.